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Backgrounder

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How Do I Tax Thee? Choices Made on Federal Income Taxes

by

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Finance Minister Paul Martin's February 24, 1998, budget lays out several proposals for minor reform of federal personal income tax. The changes apparently are aimed at lowering the effective tax burden borne by low- and middle-income Canadians.

A hard look at the specifics of the proposals, however, uncovers a number of rather worrisome aspects of this budget. While the proposed measures do promise a slight lightening of the overall income tax weighing on Canadians, they do so at the expense of worsening incentives for taxpayers across a wide range of income levels. The prospect of increasing the tax bearing on each extra dollar Canadians earn will raise serious questions about the wisdom of aggressive targeting of fiscal benefits.

The budget contains three broad measures available in principle to all Canadians:

- a small increase in the basic personal exemption, structured for the benefit of single taxpayers with income below about $20,000 — or couples with income below about $40,000;
- the elimination of the 3 percent income tax surtax for taxpayers whose incomes is below about $50,000; and
- an increase in the maximum deductible amount with respect to child-care expenses, of use only to those who are using the child-care expense allowance to the full.

What is the overall impact of these tax changes? How does that impact compare with some of the available options? And to what extent do the proposals make economic sense, especially as compared with the alternatives?

Paul Martin's Choice

The first of the proposed tax changes is a new credit, the supplementary personal income tax credit. This is to be calculated in parallel with the existing basic federal tax mechanism, but it is designed to indirectly increase the amount

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of taxable income protected from taxation by the basic personal exemption, now set at $6,456. The arithmetic of the new credit effectively increases the basic personal exemption to $6,956, but only for taxpayers whose taxable income is not a penny more than that amount. For those with income above $6,956, the bottom income tax rate of 17 percent comes into effect; the new credit is simultaneously reduced with increasing income, so that the value of the credit goes to zero for those with an income near $20,000. For taxpayers with spouses or dependents for whom they are eligible to claim the equivalent-to-married amount, up to $500 more in income may be sheltered from federal income taxation.

The finance minister's second tax proposal is to eliminate the federal income tax surtax for taxpayers whose otherwise payable surtax is no more than $250. For taxpayers whose surtax falls above that amount, the $250 is reduced by 6 percent of the amount that their basic federal tax exceeds $8,333, a point that is reached when taxable income goes above about $46,000; the phaseout of the surtax reduction is exhausted at an individual taxable income of about $62,000.

The third tax measure of broad interest to low- and middle-income Canadians is an increase in the maximum allowable deductible amounts with respect to paid child care. The maximum allowable for a child under seven will increase from $5,000 to $7,000, and the maximum for an older child from $3,000 to $4,000. These deductions are taken from net income in arriving at taxable income, so the dollar reduction in federal tax otherwise payable depends on the tax rate the taxpayer faces. For a taxpayer able to take advantage of an increase in the maximum allowable deduction of $3,000, federal tax payable will be reduced by an amount ranging from just over $500 to over $900, depending on income. The taxpayer will also benefit from a drop in provincial income tax payable worth about 50 percent of the federal tax saving, depending on the provincial tax rate.

The first two proposals are slated to have half their fully implemented impact in 1998 and to take full effect in 1999. The child-care expense allowance increase is intended to be fully effective for 1998.

Selective Cuts, Selective Increases

If these three proposals were fully implemented in 1998, total savings for federal taxpayers would be upward of $1 $^{1}/_{3}$ billion.

What does the distribution of this apparent windfall look like? If one divides families and individuals by income level, 52 percent of the dollar gain goes to the two-thirds who are in the lower-income brackets. The average dollar benefit of the tax cuts is modest, but it does amount to just over a quarter of 1 percent of income for the low-income groups. Since the proposals are intended to be of greater relative benefit to low-income taxpayers, it is natural that the benefit for the higher-income third of families and individuals is a still more modest 0.18 percent of income. Looking across family types, 48 percent of the dollar gain is delivered to families with young children and the remainder to all other family types and individuals.

Thus, a small but real benefit is in the offing for low-income taxpayers. But what message is the finance minister sending?

The economics of the proposed tax cuts are not at all encouraging. The apparent desire to narrowly target the benefit has spawned credit mechanisms that give with one hand and take with the other, to little good effect. Taxpayers with very low income — for example, singles with income between $6,456 and $6,956 — are spared both the personal income tax rate of 17 percent and the 3 percent surtax. But should those taxpayers venture to increase their income above $6,956, they would find that the federal tax take on their next dollar of income has increased, not decreased. This is because, for these taxpayers, the surtax rate (which they

would not pay under the proposal) has an effective take of 0.51 percent of the next dollar of income. The new supplementary credit reduction mechanism, on the other hand, will create an effective tax rate of 0.68 percent on the next dollar of income — that is, the 4 percent reduction rate of the credit, specified in the budget, multiplied by the 17 percent credit rate applied to taxable income. The cost of the new credit reduction applicable to each extra dollar earned is higher than the surtax would have been. So, while the *tax bill* of the average low-income taxpayer has been reduced, the *marginal tax rate* that taxpayer faces has actually increased. This necessarily produces a worsened marginal incentive for Canadians to earn income, save, and invest.

For taxpayers a little higher up the income scale, incentives are not worsened. Single taxpayers with income above $20,000 are unaffected by the reduction of the supplementary credit — but neither do they benefit from that credit. This group does profit from the surtax reduction, whose effect is to eliminate any income tax surtax otherwise payable, up to a maximum of $250. For middle-income earners, however, the trouble returns, since the surtax reduction is itself reduced at the rate of 6 percent of basic tax payable for those with taxable income above $46,000. A taxpayer at this level is already paying federal tax at the 26 percent rate, so the surtax reduction will boost the marginal rate from 26.8 percent (including the surtax) to 28.3 percent. This constitutes another marginal tax rate increase, and therefore another heightened earning disincentive.

This is the axis along which one can assess other options for small-scale tax reform. Given the same resources the finance minister has proposed using, how do the options he has chosen compare with other available options? Are his choices as well targeted? Do other choices offer better incentive effects or make better long-run economic sense?

Stop the Robbery

One worthy option is to fix the de-indexation of the personal income tax system, the "stealth tax" Finance Minister Michael Wilson imposed on every taxpayer in his May 23, 1985, budget.

From 1974 until 1985, all the important taxation parameters — the values of the basic personal exemptions, nonrefundable and refundable credits, and the income levels at which tax rates jump — were increased each year by the annual inflation rate as measured by the consumer price index (CPI) for the 12-month period ending the preceding September 30. This process, known as indexing, ensures that taxpayers are not pushed from one tax bracket to the next by the purely inflationary component of their income growth, thereby protecting their after-tax income from "bracket creep."

Wilson's 1985 budget introduced the CPI-minus-three rule, meaning that the inflation adjustment for personal exemptions and tax brackets would thereafter reflect only the amount by which annual inflation exceeded 3 percent.

Since inflation has stayed below 3 percent since 1992, there has been no change whatever in the credit values since that year. So, while the CPI-minus-three rule is often referred to as "partial indexation," in a world with reasonably low inflation it is the same as no indexation at all. Suppose a taxpayer earning $29,000 in 1998 faces a basic federal tax rate of 17 percent on his next dollar of income. If annual inflation averages 2.5 percent from now into the future, that taxpayer will sail through the middle 26 percent bracket and reach the top bracket of 29 percent by 2027, even if he does no better than keep up with inflation. At any inflation rate above 3 percent, he makes it to the top bracket by 2022, even if his real income never changes. If this "cradle-to-grave robbery" is not fixed, in just a few short decades every working Canadian will be paying income tax at the top marginal rate.

To date, de-indexation has meant that the basic personal exemption, set at $6,000 in 1988, has been held at $6,456, rather than the $7,983 it would have reached in 1998 had the system been indexed. The middle-rate tax threshold, set at $27,500 in 1988, would now be $36,589 instead of $29,590. And the net income level above which the child tax benefit, the goods and services tax credit, and the age tax credit are each reduced would have grown from $23,500 in 1985 to $33,980 by 1998, instead of the $25,921 at which it now sits.

The cumulative impact of de-indexation is that net federal revenue for 1998 will be more than $10 billion higher than if indexing had persisted. Finance Minister Martin could therefore credit about $10 billion in deficit reduction to stealthy tax increases imposed by Michael Wilson.

Restoring the full-indexing rule is one way to stop the robbery. This would not mean correcting every exemption, credit, and benefit to its inflation-adjusted 1985 value, although that $10 billion budget buster would certainly be a boon to taxpayers. Reversion to the old rule is more readily affordable, but it might be better to start with credit increases that would allow a little catch-up with inflation. If the $1 $^1/_3$ billion hypothetical tax cut for 1998 were applied instead to evenly increasing each credit and benefit affected by the indexing rule, the affordable adjustment would be about 2.5 percent, making up for the past 1 ½ years of missing indexing. The basic exemption, for example, would increase to $6,619 from $6,456, and the 26 percent tax rate would cut in at $30,337 instead of $29,590.

That change would see about 48 percent of forgone federal revenue allocated to families with young children. Dividing individuals and families by income level, about 52 percent of the money would go to the bottom two-thirds and the remaining share to the upper third of income earners. Inflation indexing naturally delivers large absolute dollar numbers to upper-income earners, mostly because of the way tax brackets work: high-income earners receive a benefit from increasing the level at which the bottom tax rate jumps from 17 to 26 percent just as low-income earners do; high-income earners also benefit from the increase in the level at which the rate jumps from 26 to 29 percent, which low-income earners do not.

But simple arithmetic shows that the basic exemption and refundable credits are more important elements in calculating the tax liability of low-income taxpayers than those credits are for high-income taxpayers. This means that the relative cost of de-indexation to low-income earners is larger than it is for high-income taxpayers. So, on a percentage basis, as opposed to absolute dollars, low-income earners fare better than others through re-indexation. The 2.5 percent increase in exemptions and credits yields a benefit for the lower two-thirds of families of one-quarter of 1 percent of average income, while for the upper third the figure is one-sixth of 1 percent of income.

The particular merit of restoring indexation is that it requires no further policy action on the part of the federal government. Once proper inflation adjustments are back in the tsax code, governments that would like to appropriate an ever-larger share of Canadians' income will have to do so by explicit policy action, rather than by allowing inflation to do the dirty work. The measure does not preclude further *ad hoc* increases in the exemption levels as they become affordable, but in the meantime re-indexation would eliminate that pernicious bracket creep.

One drawback to the re-indexation option is that it would not directly address the high tax rates that irk so many Canadians and tax policy experts. But by bumping up the values for the tax brackets and exemptions, re-indexation would cut back on the proportion of Canadians who are otherwise being steadily pushed into higher tax brackets by inflationary growth in their income.

The Basics

Another option would be to raise the basic personal exemption. Since low-income earners, in particular, depend on the basic exemption to reduce their tax payable, what would happen if the same billion dollars from above were "spent," with no other changes, on raising the basic exemption, not to $6,579, as in the re-indexation case, but to $7,018? How would this option fare from a distributional perspective?

Compared with re-indexing, this option would work better in some senses and worse in others. The change would deliver only about 35 percent of the total dollar value of the tax reduction to families with young children, compared with 48 percent in the re-indexing case. This is because many of the credits and exemptions that are increased by re-indexing would be unavailable to singles and families without young children, whereas the basic exemption is of use to all taxpayers. Divided by income, about 54 percent of the benefit would go to the lower two-thirds of families, not a meaningful difference from the 52 percent in the re-indexation case. As a share of income, the gain to both low- and high-income taxpayers would be about the same as with re-indexing — that is, the percentage contribution to improving after-tax income would be larger for low-income families.

As a one-time measure, increasing the basic exemption would not fare too badly. But it would mean that preserving the value of the tax change would require yearly discretionary action on the part of the prime minister and his cabinet. Inflation, even at 2.5 percent, would eliminate the real increase in the basic exemption in just over three years.

As an economic incentive, however, increasing the basic exemption would not fare well at all. It would certainly be useful in removing very-low-income taxpayers from the tax rolls, but the incentive would apply only to those whose taxable income remained below the value of the increased exemption. Everyone stepping above that low value would face a minimum federal plus provincial income tax rate of 25 percent. But just increasing the basic exemption for all would be a simple and clear improvement over the measures Finance Minister Martin has proposed, for this approach would worsen no one's incentives.

Less Tax on the Tax

Another option would be to deal with the federal income tax surtax, which is 3 percent of basic federal tax payable and is applicable to *all* taxpayers. Many observers and some political parties have taken aim at the surtax, arguing that it is absurd to impose it on taxpayers whose income is at subsistence levels. So, what would happen if the tax-cut money from the budget were instead "spent" on lowering the basic surtax?

In this case, the surtax rate could be cut to about a third of its present level, to a little under 1.1 percent of basic federal tax. Of the tax-cut dollar tax allocation, about 40 percent would go to families with young children. On the other hand, only 29 percent of this benefit would accrue to the lower two-thirds of individuals and families grouped by income level. This is because the value of the surtax, as a share of income, is higher for high-income earners since their basic federal tax is higher as a share of income — and the surtax is a tax on the tax. Thus, the tax cut would be only 0.15 percent of income for those in the low-income brackets, but 0.27 percent for high-income individuals and families.

While the distribution of benefits under this option would not be the best possible, given the saim of providing benefits to families with children or to low-income families in general, the surtax rate cut would have one important advantage over other measures: it is a real *rate* cut, meaning that it would reduce the tax grab on every extra dollar Canadians earn. The result, above and beyond the immediate benefit of the tax reduction, would be improved incentives to work, save, and invest, and a long-

run improvement in the growth rate of Canadian incomes.

The Tax on Less Tax

Could better distributional results be achieved by targeting the surtax cut to low-income taxpayers more narrowly, by levying the surtax only on basic federal tax exceeding a certain amount, as intended when the temporary surtax was inaugurated? If this option were followed, then instead of facing a 3 percent surtax — on top of a 17 percent income tax — on the first dollar by which taxable income exceeds the sum of personal nonrefundable credits, Canadians would see the surtax cut in only when the basic federal tax on that income exceeded a selected cut-in level.

Allocating the budget tax-cut money to be "spent" once again, the arithmetic would allow that cut-in level to be set at $5,398 (instead of zero) in basic federal tax before the 3 percent surtax came in to effect — typically, at a taxable income of about $35,000. Of the amount left thereby in taxpayers' hands, about 39 percent would go to families with children. Looking across income levels, about 41 percent would also be delivered to the bottom two-thirds of families and individuals ranked by income, compared with 29 percent in the surtax rate reduction example. Most tellingly, the cut-in would produce a benefit equal to 0.21 percent of income for the low-income group, and 0.22 percent of income for the high-income group. The surtax cut-in would be much better geared to income than is simply reducing the surtax rate.

At first, this surtax cut-in does not look like a *rate* cut, but that is what it would be for taxpayers whose taxable income is bigger than their nonrefundable credits, but not yet big enough to be faced with the surtax, given the new cut-in level. Thus, this measure would have the same clear economic merit as does the surtax rate cut, but it would apply only to relatively low-income earners. These taxpayers would receive an effective rate cut, which would improve their incentive to work and save. Upper-income earners would receive an implicit lump sum benefit through the nonapplication of the surtax to the first portion of their income and, best of all, they would not face the marginal rate increase created by Finance Minister Martin's proposed surtax reduction mechanism.

Just Plain Lower Taxes

Another option, and one of the best defended, would be to lower the bottom personal income tax rate, which was set at 17 percent in the major tax reform of 1988.

How far would $1 $^1/_3$ billion go in reducing the bottom rate? Not very far — it could go from 17 percent to just under 16.6 percent, which does not sound like much. But this measure would have a reasonable distribution of benefits, with 37 percent of the money going to families with children, or 48 percent going to the lower two-thirds of families and individuals grouped by income. And compared with the surtax phase-in, the distribution would be better, with low-income families having their tax reduced by 0.24 percent of income, while high-income families would see their taxes cut by 0.20 percent of total income.

Another advantage of cutting the bottom tax rate is that it would be a *rate* cut, like the surtax rate cut, which means that it would have good economic incentive effects. But because it would be a cut only to the bottom rate, it would offer no improved work incentives for high-income earners. Those earners would benefit from the rate reduction on their first $29,590 in taxable income, but the tax rate on each extra dollar they earn would remain the same.

A Taxing Lesson?

Finance Minister Martin's budget proposals, like the alternatives evaluated here, deliver small but meaningful reductions in the

Tax Reduction Tally Sheet: The Distributional Impact and Economic Incentive Effects of Selected Tax-Cut Options

Tax-Reduction Option	Benefits to Lower Two-Thirds of Families *(percentage share)*	Benefits to Families with Children *(percentage share)*	Economic Incentive Impact
1998 budget: supplementary basic tax credit, surtax reduction, child-care expense increase	48.8	42.9	Marginal tax-rate increase is negative for taxpayers already earning income; average rate cut is positive for new labor market entrants
Restore inflation indexing	51.7	48.1	Mildly positive; across-the-board average rate cuts; future taxpayers protected from automatic marginal and average rate increases
Increase basic exemption	53.9	35.3	Neutral for current taxpayers; average rate cut positive for new labor market entrants
Reduce surtax rate	29.2	40.1	Strongly positive marginal incentives for all taxpayers
Introduce surtax cut-in	41.2	38.8	Strongly positive marginal impact for low-income earners, neutral for high-income earners
Reduce bottom tax rate	48.3	36.6	Strongly positive marginal impact for low-income earners, neutral for high-income earners

amount of taxes that Canadians, particularly those at the low end of the income scale, pay.

But this is not the only criterion for scoring tax options, nor is it necessarily the most important. The same can be said of criteria such as the relative allocation between families with and without children, and of the share of personal income saved by taxpayers of differing income levels. There is no weighting system that tells us how a good score on one axis is to be counted against a poor score on another. While the table shown here can regularize how the discussion is framed, it does not lend itself to summing across columns.

Common sense does, however, prove a useful guide to decisionmaking. If incentives matter in Canadians' decisions about working, saving, and investing, then tax rates are of great concern. And the important tax rate in determining incentives is the one associated with each extra dollar of earned income. Given this widely accepted lesson, it is at least easier to pick out options that make more sense than others.

In particular, the convoluted tax credit give-and-take that the current budget proposes worsens incentives for many Canadians. Given that there are many ways to achieve

similar distributional goals, at equivalent cost, and without worsening incentives for anyone, a long, hard, second look ought to be given the budget tax proposals before they proceed to the legislative agenda.

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